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March 16, 2021

VIA E-MAIL

Subcommittee on the United Nations Model Tax Convention between Developed and Developing Countries

Re: Comments on the Discussion Draft on the Inclusion of Software Payments in the Definition of Royalties

Dear Subcommittee Members:

The Software Coalition[1] thanks you for the opportunity to provide comments on the Discussion Draft (the "**2021 Discussion Draft**") on the inclusion of software payments in the definition of royalties in Article 12 of the United Nations Model Tax Convention between Developed and Developing Countries (the "**UN Model**"). We appreciate that the Subcommittee on the Update of the United Nations Model (the "**Subcommittee**") has invited public comment at a stage before the United Nations Committee of Experts on International Cooperation in Tax Matters (the "**Committee**") has formed a view on the topic and in anticipation of the Committee's 22nd session, currently scheduled for April 2021.

We note that the Software Coalition submitted a comment letter in response to the earlier discussion draft released on September 1, 2020 (the "**2020 Discussion Draft**"), that also proposed to include "computer software" in the definition of royalties in Article 12(3) of the UN Model (our prior comment letter is referred to as the "**Prior Comment Letter**"). We have attached a copy of our prior letter for your ease of reference. For the avoidance of doubt, the Software Coalition continues to hold the views expressed in our Prior Comment Letter.

We are writing now to provide input on the specifically enumerated questions in the 2021 Discussion Draft, as well as to express our concerns about the 2021 Discussion Draft's proposed changes to the definition of royalties in the UN Model and the Commentary to the UN Model (the "**UN Commentary**").

1. Introduction

The Software Coalition has been actively involved in international tax policy discussions regarding the characterization of payments for software since its inception, more than 30 years ago. We appreciate the opportunity to once again offer the perspectives of the software industry on the 2021 Discussion Draft.

In this letter, we will provide input on the three questions posed by the Subcommittee.

[1] The Software Coalition, which was originally formed in 1988, is an industry association representing many of the world's leading computer software companies. Members are listed on Appendix 1.

First, we suggest a clarification to the description of "software" provided in paragraph 12.1 of the Commentary on Article 12 of the 2017 OECD Model Tax Convention on Income and Capital (the "**OECD Commentary**") in order to be consistent with current business practices.

Second, we comment on the definition of "computers" and the concept of "mixed contracts" in the delivery of software as raised in paragraphs 17 and 23 of the proposed UN Commentary (the version of the UN Commentary included in the 2021 Discussion Draft is referred to herein as the "**UN Commentary, as Revised**").

Third, we address the Subcommittee's question of whether to continue to adopt paragraph 14.4 of the OECD Commentary ("**Paragraph 14.4**"). We believe that the analysis in Paragraph 14.4 reflects the correct understanding of the legal and economic nature of distribution intermediaries for software copies. Accordingly, we disagree with the arguments made in the Annex to the 2021 Discussion Draft (the "**Annex**").

Finally, we also respond more generally to the proposed revisions to the definition of royalties in Article 12 of the UN Model which would essentially cause Article 12 to apply to all transactions involving software, including amounts paid to purchase software copies. We believe that those proposed changes should be withdrawn.

2. The Description of Software in Paragraph 12.1 of the OECD Commentary on Article 12 Should Be Amended to Account for Copies Delivered via Digital Download

The Subcommittee specifically requests input on the question of whether paragraph 12.1 of the OECD Commentary on Article 12 is "(a) consistent with current business practice and (b) appropriate for use as a definition in this context, perhaps by adding the definition to Article 3" of the UN Model.

If any revisions are made to the UN Model and UN Commentary pursuant to the 2021 Discussion Draft, we would propose that the definition of software in paragraph 12.1 of the OECD Commentary as extracted in paragraph 12 of the UN Commentary, as Revised, should be amended as follows:

> Software may be described as a program, or series of programs, containing instructions for a computer required either for the operational processes of the computer itself (operational software) or for the accomplishment of other tasks (application software). It can be transferred through a variety of media, for example in writing or electronically, on a magnetic tape or disk, or on a laser disk or CD-Rom. ***Copies of software can also be delivered via digital download.*** It may be standardised with a wide range of applications or be tailor-made for single users. It can be transferred as an integral part of computer hardware or in an independent form available for use on a variety of hardware.

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We would propose this change to modernize and clarify the definition of software. It appears that the phrase "for example in writing or electronically" describes only the various ways in which software can be transferred *on media*, meaning that the definition does not directly acknowledge that software copies can be transferred via digital download. There should be no different tax treatment for copies delivered digitally and those delivered on tangible media, as those two forms of delivery are economically and commercially equivalent. Digital delivery is an increasingly common delivery method for software copies. Including a reference to deliveries via digital download in the definition of software will make it clear that payments for software copies should be treated the same regardless of the delivery mechanism.

3. Paragraph 17 of the UN Commentary, as Revised, Should be Amended to Provide Additional Clarity and Certainty

Paragraph 17 provides that consumer goods that contain software that improve the good's performance or functionality (*e.g.*, the onboard advanced electronic systems in an automobile) should not be viewed as "computers." Paragraph 17 goes on to state that the reference to "computer software" in Article 12(3) "is not intended to encompass [software embedded in consumer goods] when the fundamental purpose of the transaction is the purchase of the good and such software cannot be purchased independently of the good."

The more significant issue raised by the Subcommittee's question relates to the reference to the concept of "mixed contracts" in paragraph 17 of the OECD Commentary on Article 12. In our experience, that Commentary paragraph has not provided useful guidance, as the concept of "mixed contracts" is not a commercially useful reference. We agree with the statement in the UN Commentary, as Revised, at paragraph 17 that a separate purchase of software to be installed in equipment should be analyzed as a software transaction. Similarly, in cases of bundled transactions where equipment with embedded software is sold under a single commercial contract, that transaction should be treated solely as a sale of the equipment. Accordingly, we would suggest that the UN Commentary not include a reference to the "mixed contracts" concept.

We agree that a separate transaction for a copy of computer software only, should be treated as a software transaction regardless of whether the software copy can be downloaded and used in connection with some other consumer good (*e.g.*, a navigation software program that can be downloaded to an automobile's on-board computer). We do not believe, however, that this type of transaction should be covered by Article 12(3) of the UN Model unless the purchaser acquires the use of, or the right to use, the software copyright. If our recommendation to withdraw the proposed changes to Article 12 of the UN Model are not adopted, then the UN Commentary should take into account the proliferation of consumer goods with embedded software. Accordingly, we believe that the only hypothetical circumstance in which a transaction whereby a user acquires a software copy which runs in a software enabled device should be considered a software transaction (*i.e.*, covered by

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Subdivision (a)(iv) and Subparagraph (c)[2]) is when there is a separate commercial contract containing a separate stated price for the software program. For the avoidance of doubt, our comment is only a hypothetical case, as we fundamentally believe that payments made in consideration for software program copies should not be within scope of Article 12 in any circumstances, as discussed further below.

4. The Software Coalition Agrees with the Analysis in Paragraph 14.4 of the OECD Commentary on Article 12

The Subcommittee's final specific request for input was on Paragraph 14.4 and whether Paragraph 14.4 appropriately classifies arrangements involving distribution intermediaries.

We agree with the apparent majority of Committee members that Paragraph 14.4 is an accurate reflection of the commercial, economic, and legal realities of transactions in respect of software involving distribution intermediaries. Accordingly, we disagree with the analysis in the Annex. Our view is based on both the actual facts of how software copies are distributed, and the nature and purpose of the "distribution" right under copyright law.

4.1 Examples of Software Distribution that do not Infringe the "Distribution" Right under Copyright Law

In general, the so-called distribution right relates to the authority of the copyright holder to control the distribution of copies that the copyright holder has produced and placed into the market. Accordingly, the distribution right can be exercised only by a distribution intermediary which controls the further transmission of software program copies.[3] .

In most modern software distribution methods involving intermediaries of the sort described in Paragraph 14.4, the distribution intermediary does not exercise the distribution right, even where such a right exists under relevant national law. For example, distribution intermediaries do not exercise any distribution right in cases where users are given access to software functionality under SaaS models or where users receive digital downloads of copies directly from the copyright owner. In the former case, there is no copy over which the distribution intermediary can exercise control. In the latter case, the distribution intermediary does not receive possession of a copy of the software program. Even in cases where the software is shipped on tangible media, the distribution intermediary does not exercise a

[2] Article 12(3)(a)(iv) is referred to herein as "**Subdivision (a)(iv)**" and Article 12(3)(c) is referred to herein as "**Subparagraph (c)**."

[3] The Annex contains only one sentence on the general nature of the "distribution right". Most of the Annex addresses national law differences in applying the principle of exhaustion. A more complete statement of the distribution right is that a distribution right can be infringed by anyone who distributes copies of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending in a jurisdiction that recognizes an exclusive distribution right for the copyright owner – unless the copyright owner consented (e.g., in a distribution license agreement) or the first sale doctrine applies and the distribution right has become exhausted with respect to a particular copy. In cases where the distribution intermediary in fact does not control actual distribution of the copies themselves, however, this right is not implicated or infringed by the business activity of the distribution intermediary.

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distribution right when the physical copies of the software program are drop-shipped to end- users by the copyright owner.

All of the statements in the immediately preceding paragraph remain true in circumstances in which end-users enter into user agreements with distribution intermediaries and the agreements include the typical use restrictions contained in ordinary user license agreements. This is because the user agreement controls what use the user may make of the copy; it does not change the facts as to how the copy was delivered from the copyright owner to the user.

The remaining case is where a distribution intermediary receives and stores copies of software before reselling such copies to users. It is clear that this distribution model accounts for a small, and shrinking, portion of overall trade in computer software. As the Annex notes, even in these cases under the laws of many countries, the sale of the software packages to the distribution intermediary will exhaust any distribution rights of the copyright holder, so that the distribution intermediary could no longer infringe (and thus be regarded as exercising) any distribution right of the copyright holder.

4.2 National Law Treatment of the "Distribution" Right

As the Annex notes, there are significant differences in national law regarding the existence and interpretation of the so-called distribution right. The Appendix helpfully reproduces selected portions of the copyright laws of a few states. It is important to note that those excerpts show that in some cases, the quoted national law does not refer to a "distribution" right at all.

Domestic copyright laws are not uniform as they relate to the application of the distribution right to sales by distribution intermediaries. As the Annex notes, national laws are not consistent in their treatment of the exhaustion doctrine as it relates to the distribution of computer software. For example, in the EU, the *UsedSoft* case[4] establishes that, except in certain unusual cases, for sales of copyrighted software copies in or into an EU member state, the exhaustion doctrine applies. The EU Court of Justice emphasized that contractual clauses are to be disregarded and a sale is to be assumed relating to any transaction where the recipient pays a one-time fee for the software. The first sale doctrine – and exhaustion of any distribution rights – applies even where a software copy is downloaded or made available under end-user license terms. Under the *UsedSoft* case, in general no distribution intermediary as described in Paragraph 14.4 could be regarded as exercising a distribution right on its purchase and resale of a software copy in the EU. We note that the Annex does not refer to this very relevant doctrine covering several of the countries listed in the Appendix.

Finally, it is important to note the purpose of the distribution right under the copyright law. The distribution right is appurtenant to the reproduction right. The central purpose of the copyright law is to protect the right of the copyright owner to reproduce copies of the work

[4] Judgment of the European Court of Justice (Grand Chamber) of 3 July 2012, *UsedSoft GmbH v. Oracle Int'l Corp.* (Case C-128/11) (1), Official Journal 2012/C 287/16.

and to place those copies into commerce. As such, the "distribution" right itself is ancillary to and supportive of the reproduction right, as opposed to being a substantial right with economic value on its own. Consistent with this view, we note that the Berne Convention for the Protection of Literary and Artistic Works (the "**Berne Convention**")[5] does not prescribe a distribution right and does not dictate any other specific rights. The Berne Convention simply states that countries must give the same rights to copyright owners in other treaty jurisdictions that they give to their own.

For this reason, the U.S. regulations regarding software revenue characterization and the OECD Commentary state that in general, a copyright licensee must exercise both the reproduction and distribution rights in order for the payment to be characterized as a royalty.[6]

4.3 Paragraph 14.4 Represents the Best Harmonization of Law for Distribution Intermediaries

Paragraph 14.4 is an appropriate harmonization of the legal principles described above, and is the most accurate reflection of the economic reality of payments by distribution intermediaries. Paragraph 14.4 expresses a very important principle in the context of software transactions that has proved in practice to be understandable to taxpayers and administrable to tax administrations. Paragraph 14.4 also establishes parity between arrangements involving the resale and distribution of software copies and arrangements involving the resale and distribution of any other good, including other copyrighted articles such as books, audio content and visual content.

This view is supported by a recent decision by the Supreme Court of India. On March 2, 2021, in *Engineering Analysis Centre of Excellence Pvt. Limited v. CIT,*[7] the Court held that payments for licensing and distributing computer software are not subject to tax as royalties in India under India's various tax treaties. Most, if not all, of India's treaties are based on the UN Model. The Court specifically found that payments made by Indian end-users and Indian resellers to foreign computer software manufacturers and suppliers are not taxable as royalties in India. In its holding, the Court explicitly referenced and correctly applied Paragraph 14.4 in the reseller context. The Court's decision is important validation that Paragraph 14.4 represents the appropriate technical interpretation of an arrangement between a software copyright owner and a foreign distributor that is granted the right to distribute software copies without the right to reproduce the software program. The Indian Supreme Court's decision is also confirmation that, as a legal and economic matter, the analysis according to Paragraph 14.4 is the appropriate interpretation of existing Article 12(3) of the UN Model.

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[5] *Opened for signature* Sept. 9, 1886, 828 U.N.T.S. 221 (revised at Paris, July 24, 1979).

[6] *See* Treas. Reg. § 1.861-18(c)(1)(i) and (c)(2)(i) providing a transfer of a computer program is classified as a transfer of a copyright if a person acquires any of the four specifically enumerated copyright rights, including the right to make copies of the computer program for purposes of distribution to the public by sale or other transfer of ownership; Paragraph 12 of the UN Commentary to Article 12, referencing Paragraphs 13.1 and 14.4 of the OECD Commentary to Article 12.

[7] Civil Appeal No. 8733 of 2018; Civil Appeal No. 8734 of 2018.

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Paragraph 16 of the UN Commentary, as Revised, provides that economically equivalent transactions should be treated the same. Paragraph 16 expressly states that regardless of whether relevant commercial law treats the transfer of a software copy as a "license" or a "purchase" of the copy, the tax treatment should be the same. We think that this sentiment is broadly applicable including with respect to any differences in national law treatment as to whether a distribution intermediary may or may not exercise a "distribution" right in cases described in Paragraph 14.4. There should be no difference in tax treatment if a distribution intermediary transacts in software copies, books, videotapes or any other copyrighted work.

For the reasons stated in this section, we believe that any revision of the UN Model and UN Commentary should confirm that Paragraph 14.4 remains an accurate reflection of the economic, legal and commercial realities of software transactions involving distribution intermediaries.

This point is separate from the question of whether the clause "for the purpose of using it" should be included in the new proposed Subparagraph (c). We address that point below.

5. The Proposed Changes to Article 12(3) Should be Withdrawn

The 2021 Discussion Draft proposes amending the definition of the term "royalties" in paragraph 3 of Article 12 in two ways. We believe that both proposed amendments should be withdrawn, but for different reasons. The proposed changes are as follows (changes are shown in ***bold italics*** or ~~strikethroughs~~):

> The term "royalties" as used in this Article means payments of any kind received as a consideration for:
>
> ***(a)*** the use of, or the right to use,
>
> ***i)*** any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting***;***
>
> ***ii)*** any patent, trade mark, design or model, plan, secret formula or process***;***
>
> ***iii)*** ~~or for the use of, or the right to use,~~ industrial, commercial or scientific equipment; or
>
> ***iv)*** ***computer software;***
>
> ***(b)*** information concerning industrial, commercial or scientific experience***, or***
>
> ***(c)*** ***the acquisition of any copy of computer software for the purposes of using it.***

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5.1 The Proposed Reference to "Computer Software" in Article 12(3)(a)(iv) Confuses the Difference Between a Copyright Right and a Copyrighted Article

In our Prior Comment Letter we had noted that adding the term "computer software" was not consistent with the structure of Article 12(3). We repeat that comment here.

As was the case with the 2020 Discussion Draft, adding the term "computer software" to the list of items in Article 12(3) confuses the difference between a copyright and a copyrighted article. If Subdivision (a)(iv) was intended to refer to the use of the copyright itself, then Subdivision (a)(iv) is superfluous to Subdivision (a)(i). Consideration for the use of, or the right to use, a software copyright would fall within subdivision (i) of subparagraph (a) of Article 12(3) (*i.e.*, "copyright of literary, artistic or scientific work").

If Subdivision (a)(iv) was intended to refer to a software program copy, then Subdivision (a)(iv) improperly inserts a copyrighted article (*i.e.*, a copy of a software program) into the list of items the payment for which properly give rise to royalty treatment. Treating payments for software program copies as giving rise to royalties would differ from the way that the UN Model treats payments for any other type of copyrighted article. For example, payments for books, records or videotapes would not give rise to a royalty. Instead payments for these items normally would be treated as giving rise to business profits under Article 7.

It also would be superfluous with proposed Subparagraph (c), which is intended to describe payments for the purchase of copyrighted articles.

5.2 The "Letting" Analogy Confuses the Distinction between Intangible Property and Copyrighted Articles

Paragraph 14 of the UN Commentary, as Revised, ("**Paragraph 14**") proposes a justification for adding Subdivision (a)(iv) on the basis that Article 12 is intended to cover payments with respect to the "letting" of property. Paragraph 14 also asserts that payments for the use of, or the right to use, computer software constitutes a payment for the "letting" of intangible property in the same way that a payment for the use of, or right to use, industrial commercial or scientific equipment ("**ICSE**") is a payment in consideration for the "letting" of tangible property.

We do not believe that the "letting" analogy supports including payments for software in Article 12. The term "equipment" refers to tangible property. Software is not tangible property and therefore should not be considered to be equipment.[8] Accordingly, the letting analogy is inapplicable in the context of software transactions.

Instead, we agree with the important points expressed in Paragraph 15 of the UN Commentary, as Revised ("**Paragraph 15**"). We agree that there is a distinction between a transaction involving the use of a copyright right and a transaction involving the use of a

[8] *See* Paragraph 13.2 of the commentary to Article 12 of the UN Model confirming that "equipment" does not include intellectual property.

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copyrighted article. We also agree that the acquisition of standardized computer software is comparable to the purchase of a book or any other good and should be treated as giving rise to business profits instead of royalties.

5.3 Subparagraph (c) Should be Withdrawn

We understand that the purpose of adding Subparagraph (c) would be to allow source based taxation on all payments for all acquisitions of software copies. Accordingly, this would cover transactions which do not constitute payments for the right to use the software copyright, as described by Article 12(3)(a)(i).

We suggest that this proposal be withdrawn. We see no basis for imposing special, different source based tax on payments for software copies, when the UN Model does not allow source based taxation for the purchase of any other good passing in commerce, including copies of other digital content, such as books, video content, and audio content. Payments in consideration for the acquisition of software program copies should be treated as giving rise to business profits under Article 7, as is the case with every other payment for the acquisition of articles carrying copyrighted content.

6. The Coordination Rules Provided in Paragraphs 20 through 22 of the UN Commentary Can be Simplified

Our comments above would resolve many of the coordination issues raised in paragraphs 20 through 22 of the UN Commentary, as Revised. A transaction classified as a payment for the use of, or the right to use, the underlying copyright itself, would be treated as a royalty under Article 12 of the UN Model similar to any other license of the right to exploit a copyright. Transactions which are classified as the sale or lease of a copyrighted article should fall under Article 7 as business profits.

Transactions which are classified as a service would not fall within Article 12 of the UN Model. Payments for services normally would fall under Article 7 as business profits, but also could fall within the scope of Article 12A or 12B depending on the nature of the service. The issue of classifying a transaction as a license to exploit a copyright, a sale or lease of a copyrighted article, or a service strictly speaking is not one involving an overlap. Those issues are definitional, as they determine which Article covers those separate types of transactions.

For the avoidance of doubt, the Software Coalition opposes the inclusion of Article 12B in the UN Model. Article 12, as applied in accordance with the suggestions in this letter, would appropriately define that specific category of transactions which should be within the scope of Article 12, namely payments for the right to reproduce and distribute copies to the public.

7. Role of a Model Treaty

A model convention is intended to provide a harmonized framework that should facilitate international commerce. The 2021 Discussion Draft suggests that the nuances of the domestic copyright law of states might cause disparate treatment of payments for similar

transactions in other states. The purpose of a model convention and its commentary should be to provide a single, consensus cohesive framework that leads to predictable, understandable and administrable economic and legal results for taxpayers and tax administrations across all jurisdictions which follow the model in their bilateral treaty negotiations. The focus on the subtleties of various countries' domestic copyright laws in this draft does not advance that goal.

The proposed changes to Article 12 are unlikely to be accepted in treaty negotiations by countries which are the residence countries of most exporters of computer software. Accordingly, we do not regard this proposal as one which is appropriate for a model treaty.

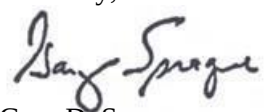
8. Conclusion

For the reasons discussed above and in our Prior Comment Letter, we recommend that the Committee should not adopt the proposed revisions to Article 12.

* * *

We would welcome the opportunity to meet with the Subcommittee to discuss our comments and are prepared to provide additional input as needed. In particular, we would be pleased to provide a presentation on our paper at the Subcommittee's next meeting in advance of the Committee's 22nd session currently scheduled for April 2021.

Sincerely,



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Appendix A

Software Coalition Members

Adobe Inc.
Amazon.com, Inc.
Autodesk, Inc.
BMC Software, Inc.
Broadcom Inc.
Cisco Systems, Inc.
Electronic Arts Inc.
Dell/EMC
Facebook, Inc.
GE Digital
Mentor Graphics Corporation
Microsoft Corporation
NortonLifeLock, Inc.
Nuance Communications, Inc.
Oracle Corporation
Palo Alto Networks, Inc.
Parametric Technology Corporation
Pivotal Software, Inc.
ResMed Inc.
Salesforce.com, Inc.
SAP America, Inc.
Synopsys, Inc.
VMware, Inc.

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Appendix B

The Software Coalition's Prior Comment Letter on the 2020 Discussion Draft

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Asia Pacific
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Tijuana
Toronto
Valencia
Washington, DC

* Associated Firm
** In cooperation with Trench, Rossi e Watanabe Advogados

October 2, 2020

Subcommittee on the United Nations Model Tax Convention between Developed and Developing Countries

Comment on Possible Inclusion of Software Payments in the Definition of Royalties in Article 12 of the United Nations Model Double Taxation Convention Between Developed and Developing Countries

Dear Subcommittee Members:

The Software Coalition[9] thanks you for the opportunity to provide comments on the Discussion Draft (the "**Discussion Draft**") on the inclusion of software payments in the definition of royalties in Article 12 of the United Nations Model Tax Convention between Developed and Developing Countries (the "**UN Model**"). We appreciate that the UN Tax Committee has invited public comment at a stage before the Committee has formed a view on the topic. We note that the proposal does not reflect the consensus views of members of the Committee and that other members of the Committee in fact have objected to it. We believe that now is an appropriate time for the Committee to request and consider public input on the proposal.

1. Introduction

The Software Coalition has been actively involved in international tax policy discussions regarding the characterization of payments for software since its inception, more than 30 years ago. We appreciate the opportunity to offer the perspectives of the software industry on the Discussion Draft.

Our comments are based on our industry expertise on software business models and the nature of software transactions. In this letter, we will address the novel justifications for the proposal in the Discussion Draft. We will describe how, although software delivery models continue to evolve, there have been no recent industry developments that suggest that the revenue characterization principles relating to software transactions should change. We will further describe how, as a technical matter, copyright laws around the world accept the distinction between copyrighted articles and copyright rights, and why the international tax law should continue to respect that distinction. In particular, we will address the arguments raised by proponents and opponents of the proposed change in the Discussion Draft. We believe that the Committee should not adopt the proposal in the Discussion Draft.

2. Article 12 of the UN Model Reflects the Distinction between Copyright Rights and Copyrighted Articles

Paragraph 3 of Article 12 of the UN Model defines royalties to include "payments of any kind received as consideration for the use of, or the right to use, any copyright of literary,

[9] The Software Coalition, which was originally formed in 1988, is an industry association representing many of the world's leading computer software companies. Members are listed on Appendix 1.

artistic or scientific work, including cinematograph films, or films or tapes used for radio or television broadcasting." Under this paragraph, a payment for the use of, or the right to use, a *copy* of a literary, artistic or scientific work is not a royalty. A payment for the use of, or the right to use, a *copyright* is a royalty. Thus, under this paragraph, a payment for the right to use a copy of a film by privately viewing the film is not a royalty, whereas a payment to use a film copyright by publicly displaying the film or making copies of the film and distributing them to the public is a royalty.

As software is protected by copyright in virtually every country of the world, the same principles apply to distinguish transactions in a software copy from transactions in a software copyright. A payment for the use of, or the right to use, a software copyright is a royalty because a software copyright falls within the scope of a "copyright of literary, artistic or scientific work." A payment for the use of a software program copy is not a royalty, for the same reason that a payment for the use of a book, record or videotape is not a royalty.

The Discussion Draft would amend the definition of the term "royalties" in paragraph 3 of Article 12 as follows:

> The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process, ***computer software*** or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience.

The proposed addition of the term "computer software" is not consistent with the structure of Article 12(3). If the addition is meant to refer to the use of a copyright on software, then the addition is superfluous. If the addition is meant to refer to a copy of computer software, then the proposed language improperly inserts into Article 12(3) a reference to a copyrighted article that does not exist for any other copyrighted material.

3. The Committee Has Previously Addressed the Software Classification Issue

We note that the issue of the classification of payments for software was thoroughly discussed in the preceding Committee of Experts. That Committee did not reach a consensus for change, and accordingly did not propose a change to the current classification principles.

In 2016, the Subcommittee on Royalties requested comments on Possible Amendments to the Commentary on Article 12 (Royalties) (the "**2016 Note**"). The 2016 Note proposed that copyright protection of software is relevant to the question of whether a payment for a software program represents consideration for the use of, or the right to use, a copyright because copyright protection increases the value of software. In our comment letter dated

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January 12, 2017, we noted that whether a copyrighted article costs more than one that is not copyrighted does not affect the character of a payment to acquire the copyrighted article.

The Committee ultimately took no action on the proposal. We believe that there have been no developments in the copyright law around the world, or in the delivery methods used by software companies, which would warrant a different result today. Software providers continuously improve their delivery methods, the principal effect of which is to decrease the cost to customers, thereby making business customers more profitable and preserving disposable income for individual consumers. Increases in network capacity and coverage enable software developers to download their software directly onto an end user's device, essentially eliminating the need for, or the ability of, the end user to make a copy of the computer program. These enhancements creating efficient delivery methods do not change the fundamental distinction between a market exploitation license of a copyright right versus the acquisition and consumption of a copyrighted article. Accordingly, we believe that there is no basis in industry developments that warrant a change in the classification principles as applied to software transactions from the last time the Committee considered this issue.

4. Role of a Model Treaty

We note the candid statement in the Discussion Draft that members of the Committee have objected to the proposal, and that the proposal does not represent the consensus views of Committee members. We also note the cogent and persuasive arguments advanced in section 3 of the Discussion Draft why the proposal should not be adopted.

It seems clear that this is an issue on which Committee members ultimately may disagree. Under those circumstances, we believe that there cannot be an addition to a model tax convention on which there is such disagreement. The purpose of a model convention is to provide guidance to states negotiating their own bilateral conventions of terms and a framework that enjoys a broad, perhaps universal, consensus. Any pair of contracting states may, of course, choose to deviate from any model when negotiating their own bilateral treaty. The provisions of the model itself, however, need to enjoy consensus support for it to remain valid as an expression of broadly agreed principles.

We do not believe that this proposal is likely to enjoy consensus support from a large majority of those jurisdictions principally involved in the cross-border supply of computer software. Accordingly, we do not regard this proposal as one which could be included in a model treaty.

5. Addressing Arguments of the Proponents

The proposed change to the text of Art. 12(3) expressed in the Discussion Draft seeks to achieve the same result as was proposed in the 2016 Note. The proponents of this change (the "**Proponents**"), however, present novel arguments to support that result. In this section, we will comment on these arguments.

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a. Advances in communication technology and engagement of computer programs

The Proponents first observe that, with advances in "communication and information technology," software constitutes a key tool in the conduct of most businesses and allows enterprises to operate more effectively and efficiently. Based on those points, the Proponents conclude "that there is an increasing level of engagement of computer programs and other software in the economic life of States where they are used." The Proponents conclude that this statement justifies the allocation of taxing rights over software payments to source countries.

Observing that there is an "increasing level of engagement" with software in a given country only suggests that businesses and consumers increasingly regard software as an important commercial good, not that software should be treated differently from any other important commercial good. For example, we assume that the Proponents would not argue that payments for books (in either physical or digital form) should be treated as a grant of rights to exploit a copyright in the market even though books embody knowledge and information which may evidence a high "level of engagement" of books in market countries and are central to the "economic life of States."

The Proponents' argument that advances in communication technology have resulted in an increased "level of engagement of computer programs … in the economic life of States" has no relevance to the issue of whether a given transaction is a payment for the grant of rights to exploit a copyright in the market, which should be characterized as a royalty, or is a payment for the use of a copyrighted article, which should be characterized as business profits.

By referencing "an increasing level of engagement of computer programs" in the economic life of States, the Proponents appear to adopt theories similar to those being used to justify the implementation of digital services taxes ("**DSTs**") in a number of countries. In particular, the underlying justification for a number of DSTs is that, for some digital service suppliers, value is created through sustained user "engagement". Computer programs and software are valuable due to the work of software developers, not from sustained user engagement. Accordingly, this is not an appropriate justification to reallocate to the location of purchasers taxing rights over software payments.

b. Increased efficiencies of users

The Proponents also suggest that the characterization of payments should be influenced by the fact that a purchaser's acquisition of computer software makes the purchaser more efficient. Creating or facilitating efficiencies is not, and has never been, a determinant of whether a payment should be characterized as a royalty.

Increasing efficiency, productivity and reducing costs allows local business purchasers to increase their own profit potential which leads to a more competitive and profitable market with more employment opportunities for source-state residents. This increased economic activity leads to increased tax collections from both the more efficient businesses and their

employees. Generally, any business will choose to purchase products or services in order to increase profitability by improving productivity, increasing customer revenue, or reducing costs. Software products and services are tools purchased for the same reasons as any other business input. As such, payments for software products and services should not be treated or taxed differently than any other business input.

c. Distinction between copyrighted articles and copyright rights as "blurred"

The Proponents assert that the distinction between the acquisition of a copyrighted article and the rights to exploit a copyright is "blurred." We see little basis for the claim that the distinction is no longer clear. While copyright law varies somewhat from country to country, a broad international consensus has evolved over time, in both developed and developing economies, regarding the recognition and protection of copyright rights.[10] The copyright law of the vast majority of countries incorporates the distinction between the acquisition and use of copyrighted articles and the acquisition of the right to exploit copyright rights, and taxpayers and tax administrations around the world have managed to apply the distinction for many years. We have not observed any meaningful shift in the general international consensus since we commented on the 2016 Note.

In general, the copyright law reflected in international copyright conventions and the domestic copyright laws of most countries grants to the holder of a copyright certain exclusive rights, including: (i) the right to reproduce the copyrighted work; (ii) the right to prepare derivative works based on the copyrighted work; (iii) the right to distribute copies of the copyrighted work to the public; and (iv) the right to communicate, perform or display the copyrighted work publicly.[11] These rights are inherently market exploitation rights, as the objective of copyright law is to allow the creator of the copyrighted work a monopoly with respect to the commercialization of the work in the market. The acquisition and use of a software program for personal or business use, therefore, does not entail the market exploitation of a software copyright right, even if such use involves an incidental copying of the application to facilitate access to or ongoing use of the program.[12] In contrast, reproducing software for sale to the public does entail the exploitation of a copyright right because the objective of the reproduction activity is to commercialize the software copyright.[13]

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[10] *See, e.g.*, Berne Convention for the Protection of Literary and Artistic Works, *opened for signature* Sept. 9, 1886, 828 U.N.T.S. 221 (revised at Paris, July 24, 1979) (the "Berne Convention"); WIPO Copyright Treaty, *adopted* Dec. 20, 1996, WIPO Doc. CRNRIDC/94 (the "WIPO Treaty"). The World Intellectual Property Organization currently has 189 member states.

[11] *See, e.g.*, Berne Convention, arts. 9, 11, 12, 14; WIPO Treaty, arts. 6, 8; 17 USC §106 of the United States Copyright Act.

[12] See 17 USC §117 of the United States Copyright Act.

[13] Respecting the economic distinction between the acquisition of a copyrighted article for consumption or resale and the acquisition of a right to make a market exploitation of a copyright means that *de minimis* uses of copyright do not cause a transaction to be characterized as a license giving rise to royalties. See, *e.g.*, Berne Convention, art. 9(2); *see also*, WIPO Treaty, art. 10(1), providing that the holder of a copy of a copyrighted work can make copies without exercising the rights of the copyright holder, because "reproduction does not conflict with a normal

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The distinction between copyrighted articles and copyright rights applies equally to books, records, videotapes, and similar copyrighted works. For example, a customer who purchases a book does not acquire any of the copyright rights noted above, and would infringe the copyright in the book if that customer were to make and distribute copies of the book. The customer's payment for the book would not constitute a royalty under Article 12 of the UN Model. In contrast, a payment from a publisher for the right to reproduce and distribute the book would constitute a royalty under Article 12, because that payment would be in exchange for the right to exploit some of the copyright rights noted above.

d. Protection under market state intellectual property law

The Proponents argue that commercial exploitation by the software supplier is dependent on the intellectual property laws in the territory where the software user is located. The Proponents continue that non-residents benefit from the market country's legal system in that they rely upon it to protect and uphold intellectual property rights and enforce payments for transactions. The "realities of the digital age", the Proponents continue, require that the definition of royalties be expanded to apply to payments for the use of or right to use software because (i) protection afforded by the market country's intellectual property law system is critical and necessary for vendors; (ii) the telecommunication infrastructure in the market country and the market country population's competency in computers promotes the use of software; and (iii) "cheap and easy" software duplication means that software companies increasingly rely on market state protection.

Like other suppliers of copyrighted content, software companies advocate for strong, enforceable copyright law protection and respect for commercial contracts in all countries in which they have users. That desire does not distinguish software transactions from any other commercial transaction and does not justify the reallocation of taxing rights. Suppliers of copyrighted books, records, video content or other materials desire the same legal protections. Trademark owners and patent holders expect and rely on market state legal systems to prevent trademark infringement for trademarked goods and patent infringement for products incorporating patented inventions. Moreover, all commercial sellers (and purchasers for that matter) expect and rely on the legal systems of both the vendor and purchaser countries to enforce the terms of their contracts. There is no difference in the expectation of legal protection by the vendors and purchasers of copyrighted articles, trademarked goods and patented products; accordingly there is no difference in the expectation of legal protection that is relevant to the characterization of payments as royalties or business profits. Software companies rely more on end user license agreements ("***EULAs***"), as discussed in further detail below, than they do on the protections of copyright laws because the EULA between a software company and a given purchaser provides a more direct and enforceable commercial restriction on the user than does the copyright law, and can cover acts that are harmful to the

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exploitation of the work and does not unreasonably prejudice the legitimate interests of the author"; Paragraph 12 of the Commentary to Art. 12 of the UN Model, referencing Paragraphs 13.1 and 14.4 of the Commentary to Art. 12 of the OECD Model; Treas. Reg. § 1.861-18(c)(1)(i) providing a *de minimis* rule that states that a transfer of more than a *de minimis* right to prepare derivative computer programs will be characterized as the transfer of a copyright right giving rise to royalty income.

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software supplier which are not prohibited by the copyright law. Because software products are normally distributed subject to a EULA, software companies rely on market country intellectual property law remedies to police infringing behavior less than other vendors of trademarked goods and patented products which do not sell their products subject to user restrictions.

Because of the ease of reproducing software copies, software suppliers in fact suffer greater piracy of their products than do suppliers of other copyrighted articles. Accordingly, as a factual matter, the effective legal protection for software is not as strong as for other forms of copyrighted content.

e. Form of user agreement

The Proponents refer to the fact that software products normally are distributed subject to an end user license agreement ("**EULA**"). Despite the title of the agreement, a EULA does not represent a license of rights to exploit a copyright. The purchaser of a software copy does not exploit the copyright on the market; the user simply uses the copy for its intended purpose. On one level, the purpose of the EULA is similar to the copyright notice that appears at the beginning of a book, or the warning against unlawful reproduction that appears at the beginning of a video, in that the EULA cautions the customer against infringing any of the exclusive copyright rights of the copyright holder, because the customer has not been granted any of these rights.

The most important function of the EULA is to impose restrictions on customers that are *in addition to* the restrictions that copyright law already imposes. Specifically, a software supplier requires users to agree to the EULA in order to prohibit activities that either do not, or may not, rise to the level of copyright infringement. Under the "first sale" doctrine, for example, a purchaser of a software copy could legally resell the software copy without infringing the software copyright. The copyright holder may be able to prevent the application of this doctrine by including in the EULA a contractual provision prohibiting further sales of the software program copy. Similarly, the EULA may include a contractual provision prohibiting reverse engineering of the software source code, because such activity may not literally infringe the software copyright under copyright law alone.

There are, of course, many transactions involving software that do give rise to royalties. For example, a software copyright holder that licenses to a hardware manufacturer the right to reproduce and sell copies of the software loaded on the hardware in exchange for periodic payments receives royalties within the meaning of Article 12 of the UN Model. In that case, the payments are for the use of, or the right to use, the copyright for the purpose of reproducing and distributing the software to the public, and thus properly fall within the scope of "consideration for the use of, or the right to use, any copyright".

From both the economic and intellectual property law perspectives, the use of a copyrighted article, such as a software program, does not entail the exploitation of a copyright right, just as reading a book, watching a movie, or listening to music does not entail the exploitation of a copyright right. If every payment for the use of an article that enjoys copyright protection

constitutes a royalty, every payment for a book, a movie, a song, and a software application would represent a royalty that is potentially subject to withholding at source. That result is contrary to the economic substance of the transaction.

f. Analogy to lease of equipment

In Paragraphs 9 and 10 of the Discussion Draft, the Proponents note that the definition of royalties in Art. 12 of the UN Model applies to payments for the use of, or the entitlement to use, elements of intellectual property, on the one hand, and payments for the use of or the right to use industrial, commercial or scientific equipment ("**ICSE**"), on the other. The ICSE clause does not justify treating payments for the use of copyrighted articles as "royalties", for the simple reason that software is not equipment. The term "equipment" refers to a tangible property. Paragraph 13.2 of the commentary to Art. 12 of the UN Model confirms that software cannot be "equipment". The fact that a digital product (i.e., software) may be provided on a tangible medium does not change the fact that the object of the transaction is the acquisition of rights to use the digital content and not the rights to use the tangible medium.[14]

6. Addressing Arguments of the Opponents

We note that the Discussion Draft does not represent a consensus view, and in fact members of the Committee have objected to it. We believe that the members that oppose the proposal (the "**Opponents**") raise valid objections.

The Opponents argue that it is not clear why payments for software should be treated differently from payments for other goods. We agree that there is no basis to treat payments for software products differently from payments for any other good. Indeed, software copies are economically equivalent to any other manufactured good which incorporates intangible property elements. As discussed above, the sale of the right to use a software program, without the right to exercise one of the market exploitation copyright rights noted above, represents the transfer of a copyrighted article – that is, a product – and not of a copyright right. Receipts for the sale or other use of a copyrighted article are the normal business income of enterprises which supply such products. Accordingly, such payments should be considered "business profits" under Article 7.

The Opponents also observe that the argument that allocating taxing rights to the market state based on the argument that the services or goods purchased by the payor create "an increasing level of engagement in the economic life of States where they are used" is problematic. We agree that this justification is flawed. As discussed above, a software copy is a product; it does not result in "engagement in the economic life of States" by its supplier any more than does any other popular product. Even if many persons in a market state purchase software

[14] *See* "Tax Treaty Characterisation Issues Arising from E-Commerce: Report to Working Party No. 1 of the OECD Committee on Fiscal Affairs," Technical Advisory Group on Treaty Characterisation of Electronic Commerce Payments, 11-12 (Feb. 1, 2001).

products, that does not distinguish software from any other commercial good, service or raw material.

The Opponents further argue that the "underlying principles, and consistency with approaches taken elsewhere, must underpin" a reallocation of taxing rights to market countries. We agree that the Committee should seek to align the definition of royalties and the treatment of software payments with approaches taken by other bodies and in other contexts. As discussed above, most jurisdictions recognize the distinction between copyrighted articles and copyright rights and do not treat differently the acquisition for internal use of a copyrighted software article and the acquisition for internal use of a copyrighted literary article or a copyrighted artistic work.

Further, the Opponents correctly observe that the development of software is expensive and may result in tax losses in the country in which the development is undertaken, making "it particularly important that income from the licensing of software is taxed on a net basis in the state where it is developed." Any business which commercializes software products incurs more expenses than just development costs. Software suppliers which sell copyrighted software products also incur significant expenses for production and distribution, sales and marketing, customer support, G&A, and other ordinary and necessary business expenses. The nature of the revenue and expense profile of software companies is the same as any other enterprise which develops, markets, sells and supports its products. This income is income from a business, which is why payments for software products should remain classified as "business profits" under Article 7.

For the reasons discussed above, we agree with the Opponents that none of the Proponents' justifications regarding the level of use of software in a given country, the fact that software piracy is in principle prohibited by local law, the existence of a telecommunication network which allows users to download software and other content, the ease of reproduction, a low cost of downloading software, or the education or computer proficiency of the population of that country, justifies treating the normal business income of a software product supplier as anything other than business profits.

We also agree with the Opponents conclusion that software copies should not be compared to the use of ICSE for the reasons discussed above.

7. Conclusion

The distinction between exercising a copyright right and using a copyrighted article is a fundamental distinction in intellectual property law, tax law, and economic reality that applies equally to all articles that enjoy copyright protection. We do not believe that the Proponents have provided arguments that justify excluding payments for software copies and on-line software from "business profits."

We agree with the Opponents that the proposal in the Discussion Draft gives rise to a number of practical difficulties and technical challenges that are not addressed in the Discussion Draft. Given that the Committee has analyzed the issue of software revenue characterization

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for several years, given the absence of any plausible justification for treating payments for copyrighted articles as if they were royalties, and the clear lack of consensus for a significant proposed change to the Model Treaty, we recommend that the Committee conclude that the proposed change should not be made to Article 12(3).

If this Committee decides to continue considering this issue, we respectfully submit that this issue requires more time and consideration to be sure that the challenges the Opponents have noted in the Discussion Draft and those we have noted in this letter are properly addressed. We note that the term of the current Committee ends in the fall of 2021. Accordingly, there is not enough time to properly address this issue in the current Committee. If, contrary to our suggestion, the Committee chooses to continue to review the software revenue characterization issue, we suggest that the Committee undertake additional factual development as to the nature of software product transactions and consult with both public and private sector stakeholders. We would be happy to assist in any such effort.

* * *

We would welcome the opportunity to meet with the Subcommittee to discuss our comments and are prepared to provide additional input as needed. In particular, we would be pleased to provide a presentation on our paper at the Subcommittee's next meeting in advance of the Committee's 21st session currently scheduled for the end of October 2020.

Sincerely,

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Appendix A

Software Coalition Members

Adobe Inc.
Amazon.com, Inc.
Autodesk, Inc.
BMC Software, Inc.
Broadcom Inc.
Cisco Systems, Inc.
Electronic Arts Inc.
Dell/EMC
Facebook, Inc.
GE Digital
IBM Corporation
Mentor Graphics Corporation
Microsoft Corporation
Nuance Communications, Inc.
Oracle Corporation
Palo Alto Networks, Inc.
Parametric Technology Corporation
Pivotal Software, Inc.
ResMed Inc.
Salesforce.com, Inc.
SAP America, Inc.
Synopsys, Inc.
VMware, Inc.